

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
CASTLE SERVICE CENTER, INC.	:	DETERMINATION
for Revision of a Determination or for Refund	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Periods June 1, 1979	:	
through May 31, 1980 and September 1, 1980	:	
through February 28, 1981.	:	

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Petitioner, Castle Service Center, Inc., 2400 East Tremont Avenue, Bronx, New York 10461, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the periods June 1, 1979 through May 31, 1980 and September 1, 1980 through February 28, 1981 (File Nos. 801055 and 801463).

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on May 12, 1988 at 10:05 A.M., with all briefs to be submitted by August 31, 1988. Petitioner appeared by Robert C. Morse, Esq. The Audit Division appeared by William F. Collins, Esq. (Gary Palmer, Esq., of counsel).

ISSUES

I. Whether the Audit Division's determination of additional sales tax as issued against petitioner, Castle Service Center, Inc., following a field audit was proper.

II. Whether, if so, the imposition of a fraud penalty in addition to the tax determined to be due on audit was warranted and should be sustained.

III. Whether, in the event imposition of a fraud penalty is rejected, the Audit Division's alternative assertion of penalty pursuant to Tax Law § 1145 (former [a][1]) should be sustained.

FINDINGS OF FACT

1. Petitioner, Castle Service Center, Inc. ("Castle"), operated a retail "Power Test" gasoline service station during the periods at issue. The station was located at 2400 E. Tremont Avenue, Bronx, New York, and was open from 8:00 A.M. to 5:00 P.M. for the sale of gasoline and other petroleum products and repair services. Castle sold regular, unleaded and premium unleaded gasoline. In addition, there were two service bays used in performing auto repairs.

2. Castle's president was one Lufti Ahmed. He worked at Castle on a daily basis and was involved in and exercised control over all areas of its operation.

3. On or about April 23, 1982, the Audit Division commenced a field audit of the business operations of Castle. The auditor requested all of Castle's business records including, specifically, sales tax returns, Federal corporation income and New York State franchise tax

returns, sales journal, cash receipts journal, check disbursements journal, check register, cancelled checks, monthly bank statements and journal entry sheets. The auditor requested but did not receive gasoline purchase invoices and parts purchase invoices.

4. In June of 1982, the Audit Division's auditor transcribed sales and purchases from Castle's accountant's worksheets (prepared from Castle's books and records) and compared sales per said worksheets to sales per Castle's Sales and Use Tax Returns (Forms ST-100). The results of this comparison revealed that sales reported per Forms ST-100 were 534.50 percent less than sales per the worksheets. A further comparison of sales as reported per Castle's Federal corporation income tax returns for 1979 and 1980 to sales per Forms ST-100 revealed an understatement per the Forms ST-100. More specifically, the Federal returns reflected sales of \$530,286.00 and \$436,003.00, respectively, whereas the sales tax returns reported sales of \$77,442.00 and \$66,645.00, respectively.

5. Based upon review of the records supplied, the comparison results described above, and the lack of purchase invoices, the auditor determined there were insufficient source documents available to perform a detailed audit and that the available records were also inaccurate and unreliable. Thus, the auditor decided to resort to indirect audit methodologies as a means of determining the accuracy of petitioner's taxable sales and sales tax liability as reported.

6. Third-party verification of gasoline purchases by Castle was requested from Castle's supplier, Power Test Petroleum Distributors, Inc. ("Power Test"). The gasoline purchases supplied in response by Power Test were marked up at \$1.25 per gallon. This markup was based on data as to average retail selling prices for gasoline, as compiled by the Audit Division, and upon retail selling price information as supplied by Power Test. This calculation of marked-up purchases was performed to determine Castle's audited taxable gasoline sales, per sales tax quarterly period, for the audit period spanning March 1, 1979 through November 30, 1981.

7. During the period March 1, 1980 through October 30, 1981, tax remitted per Castle's Forms ST-100 totaled \$7,908.00, whereas tax due on Castle's audited taxable sales per the Power Test verification for the same period totaled \$64,051.00. The \$7,908.00 reported by Castle was deducted from the tax due on audited taxable sales to arrive at additional tax due of \$56,143.00, or a margin of error in reporting of 709.95 percent. This error rate was applied to the tax paid per Castle's Forms ST-100 for the entire audit period, re-sulting in the calculation of additional tax due in the amount of \$101,499.00 on gasoline sales. Sales of parts and repair services were calculated by taking Castle's total parts purchases per worksheets (from its books and records) for the period June 1, 1979 through March 31, 1981, and marking up such cost amount (\$28,904.00) by 200 percent over cost. This markup was to account for parts markup plus labor charges, and such percentage was taken from Audit Division guidelines based on experience from other audits. The resultant total was then divided by the number of months in said period (22) to arrive at average monthly repair sales (\$3,941.00). This figure was multiplied by the number of months in the audit period (33) and then divided by the number of quarters in the period (11), resulting in a parts sales per quarter amount (\$11,823.00), and tax of \$946.00 per quarter was computed thereon. Accordingly, total additional tax due for the audit period (gasoline sales plus parts and repair services sales) was determined to be \$111,934.00.

8. On the following dates, as specified, the Audit Division issued to petitioner, Castle Service Center, Inc., notices of determination and demands for payment of sales and use taxes due:

<u>Date of Issuance</u>	<u>Period</u>	<u>Tax Assessed</u>
9/20/82	6/1/79 - 5/31/80	\$46,281.00
12/20/83	9/1/80 - 2/28/81	16,758.00
7/6/84	6/1/79 - 5/31/80	-0-

The third such notice, issued on July 6, 1984, modified the September 20, 1982 notice via the explanation that "[t]his assessment for fraud penalty [\$21,965.50] is in addition to Notice Number S820920003B [the September 20, 1982 notice] which has been reduced to tax and maximum interest only". This July 6, 1984 notice, when coupled with the notice of December 20, 1983, which had incorporated within it a fraud penalty pursuant to Tax Law § 1145 (former [a][2]), results in the assertion of tax due, plus fraud penalty and interest, for each of the sales tax quarterly periods at issue herein.

9. In connection with the operation of Castle, and in addition to the notices of determination issued herein, Mr. Lufti Ahmed was indicted by a Westchester County Grand Jury on five counts of offering a false instrument for filing in the first degree, said indictment being filed on June 6, 1984. The instruments alleged to have been falsely filed were Castle's sales and use tax returns for the four quarterly periods spanning June 1, 1980 through May 31, 1981, and for the quarterly period spanning December 1, 1981 through February 28, 1982. On December 4, 1985, Mr. Ahmed entered a plea of guilty to one count of offering a false instrument for filing in the second degree, a class A misdemeanor, in satisfaction of the entire indictment.

10. On December 4, 1985, Mr. Ahmed also executed an Affidavit for Judgment by Confession with respect to the aforementioned plea of guilty whereby Mr. Ahmed confessed judgment in favor of the Department of Taxation and Finance in the amount of \$41,183.88, exclusive of interest and penalties due thereon pursuant to section 1145(b)(2) of the Tax Law. Mr. Ahmed's confession of judgment states, inter alia, the following:

(a) that Mr. Ahmed was aware that the plea of guilty to the crime of offering a false instrument for filing in the second degree did not prevent or preclude the Department of Taxation and Finance from initiating further proceedings against him and petitioner [Castle] for additional amounts of sales tax, penalties and interest for periods covered by the indictment as well as periods prior and subsequent thereto;

(b) that Mr. Ahmed signed and forwarded sales tax returns to the Department of Taxation and Finance which he knew to contain false and inaccurate figures with respect to gross sales and services and taxable sales and services; and

(c) that as a result of the underreporting during the period June 1, 1980 through February 28, 1982 petitioner collected sales tax as part of the price of gasoline sold and forwarded sales tax monies to the Department of Taxation and Finance in an amount less than the true amount owed.

11. Pursuant to discovery proceedings under the Criminal Procedure Law in connection with the prosecution of the indictment against Mr. Ahmed, the prosecuting assistant attorney general issued a document disclosing the existence of an oral statement made by Mr. Ahmed on July 29, 1982 to a New York State Department of Taxation and Finance auditor, and a second oral statement containing certain admissions made on June 6, 1983 to an investigator with the

New York State Department of Law and to an assistant attorney general. The statement attributed to Mr. Ahmed by the Tax Department auditor was that "he did not have the money because Power Test sold the gas to him so high that all he could do was take the sales tax money".

12. In the June 6, 1983 statement, made in the course of an interview with the two persons from the Department of Law, Mr. Ahmed admitted that the sales tax returns for Castle as filed by him were understated. He additionally identified his signature as appearing on Castle's sales tax return for the quarterly period ended February 28, 1982.

13. Mr. Ahmed testified that losses of gasoline were sustained as the result of thefts and armed robberies at Castle, and via leakage from Castle's underground storage tanks. No police reports, documentation or other evidence was offered in substantiation of these claimed losses at any time.

14. Mr. Ahmed also testified that he wrote checks to Power Test to assist his cousin, who operated a gasoline station in the Bronx near Castle's location. Mr. Ahmed's cousin was having credit difficulties, and Mr. Ahmed allegedly paid for his cousin's purchases of gasoline through his own account when his cousin could not obtain certified checks, thereafter being reimbursed by his cousin. No documentation or other evidence supporting this assertion was presented.

15. Mr. Ahmed employed on Castle's behalf at least two different accountants during the period at issue. According to Mr. Ahmed, the first accountant for Castle would pick up necessary records, prepare the sales tax returns, and return them to Mr. Ahmed for signing. This accountant assertedly left the United States in approximately October of 1979, with Mr. Ahmed unable to locate or retrieve any records then held by this accountant. Mr. Ahmed then hired an accountant for Castle who completed the sales tax returns and allegedly signed Mr. Ahmed's name to the payment checks. This accountant worked for Castle for approximately two years.

16. A review of Castle's monthly bank statements for the audit period, in comparison to its sales tax returns for the same period, indicates the following:

<u>Month</u>	<u>Bank Deposit</u>	<u>Total Deposits by Quarter</u>	<u>Reported Taxable Sales by Quarter</u>
6-79	\$ 3,007.22		
7-79	2,903.60		
8-79	47,560.00		
		\$ 53,470.82	\$ 17,104.00
9-79	42,076.89		
10-79	44,207.53		
11-79	43,476.90		
		\$129,976.32	\$ 21,090.00
12-79	54,614.93		
1-80	63,477.78		
2-80	64,135.05		
		\$182,227.76	\$ 23,640.00
3-80	55,536.96		

4-80	45,447.27		
5-80	33,125.40		
		\$134,109.63	\$ 19,508.00
6-80	27,870.74		
7-80	22,210.58		
8-80	20,821.01		
(quarter not assessed)	\$ 70,902.33	\$ 13,861.00	
9-80	31,881.52		
10-80	17,418.07		
11-80	18,521.56		
		\$ 67,821.15	\$ 11,560.00
12-80	35,557.22		
1-81	53,444.53		
2-81	42,837.05		
		<u>\$131,838.80</u>	<u>\$ 14,630.00</u>
Overall Totals		<u>\$770,346.81</u>	<u>\$121,393.00</u>

17. Some confusion was raised at hearing as to the computation and amount of the assessments at issue herein, specifically notice number S820920003B covering the period June 1, 1979 through May 31, 1980 and issued on September 20, 1982. Said notice specifies tax due for its four quarterly periods as follows:

<u>Quarterly Period Ended</u>	<u>Amount</u>
8/31/79	\$ 8,329.00
11/30/79	10,658.00
2/29/80	12,923.00
5/31/80	<u>14,371.00</u>
Total	<u>\$ 46,281.00</u>

By contrast the Audit Report workpapers reflect the following calculation of tax on a quarterly basis:

<u>Quarterly Period Ended</u>	<u>Amount</u>
5/31/79 (period not assessed)	\$ 8,329.00
8/31/79	10,658.00
11/30/79	12,923.00
<u>Quarterly Period Ended</u>	<u>Amount</u>
2/29/80	14,371.00
5/31/80	12,021.00

Totaling the four quarters assessed per the notice (8/31/79 - 5/31/80) from the audit workpapers yields tax of \$49,473.00, whereas totaling the first four quarters from the workpapers (5/31/79 - 2/29/80) yields tax of \$46,281.00. While correct addition by the Audit Division thus would have led to a higher assessment (\$49,473.00 versus the \$46,281.00 assessed), the Audit Division admits it is limited, as the result of its error, to the amount assessed per the notice of determination.<sup>1</sup>

18. Castle leased the station location from Power Test at a monthly rent of \$1,950.00. Castle sold no gasoline by credit card. According to Mr. Ahmed, Power Test directed him to sell the gasoline at a margin not to exceed 4.5¢ per gallon over wholesale cost. Power Test allowed petitioner a 1¢ per gallon rebate against rent (to a maximum of \$500.00), and a 1.8¢ per gallon rebate to help match prices with competing stations in the area.

19. Mr. Ahmed worked as an agent for the John Hancock Insurance Company for a period of approximately 15 years prior to becoming the owner/operator of Castle. He received education through the tenth grade in his native country (Jordan) and although he spoke English as a second language, Mr. Ahmed has been in America since 1962 and did not require the assistance of a translator.

#### SUMMARY OF THE PARTIES' POSITIONS

20. Petitioner contests use of the third-party information from Power Test, maintaining that it overstates petitioner's purchases, and that petitioner's records are more accurate than such third-party information. Petitioner apparently argues that a 534 percent error rate is more appropriate and accurate than the 709 percent error rate used.

21. Castle asserts that due to Mr. Ahmed's plea of guilty and the resultant aspects of the criminal proceeding, including an order that Mr. Ahmed make restitution of the \$41,183.88 amount confessed to, any additional assessment for the period September 1, 1980 through February 28, 1981 would be a duplication of liability and thus the Audit Division is prevented by the plea agreement from further assessment for such period. With respect to the plea of guilty to fraudulent filing, Mr. Ahmed contends he had no money to contest the criminal charges. However, Mr. Ahmed was represented by counsel in the criminal proceedings, and no allegations of ineffective representation have been raised.

22. Petitioner asserts that the amount shown in the Affidavit for Judgment by Confession (\$41,183.88), although apparently calculated without a markup, is more accurate and should be used in favor of the amount of tax assessed herein. Petitioner further maintains, and the Audit Division agrees, that petitioner should receive credit against any assessment herein for any payments of tax made under the criminal proceeding restitution order, and that duplication of payment is to be avoided. Finally, petitioner maintains Mr. Ahmed's asserted lack of understanding of accounting, incompetent accountants and difficult financial circumstances were

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<sup>1</sup>In similar fashion, by its Answer the Audit Division noted the July 6, 1984 assertion of a fraud penalty of \$21,965.00 as being 50 percent of the \$43,931.00 in tax assessed for the period 6/1/79 - 5/31/80. This \$43,931.00 was clearly again an Audit Division error in addition. However, as above, the amount of the fraud penalty is limited to the amount assessed (\$21,965.50), rather than 50 percent of the tax (\$46,281.00 divided by 2 = \$23,140.50).

the causes of any underreporting determined to have occurred.

23. The Audit Division asserts that due to the plea of guilty and accompanying executed affidavit for judgment by confession by Mr. Ahmed, Castle is collaterally estopped from contesting fraud penalties for the period covered by the affidavit, and further that the evidence presented supports imposition of the fraud penalty for the entire audit period.

### CONCLUSIONS OF LAW

A. Tax Law § 1138(a) provides, in part, that if a return required to be filed is incorrect or insufficient, the Commissioner of Taxation and Finance shall determine the amount of tax due on the basis of such information as may be available. This section further provides that, if necessary, the tax may be estimated on the basis of external indices.

B. Where a taxpayer does not maintain and/or make available such records, including source documents, as will allow the establishment of an audit trail and enable verification of the accuracy of returns filed, it is well settled that the Audit Division may resort to indirect audit methodologies in carrying out its audit function. However, in determining the amount of any sales tax assessment it is the duty of the Audit Division to select a method "reasonably calculated to reflect the taxes due" (Matter of Grant Co. v. Joseph, 2 NY2d 196, 206; Matter of Meyer v. State Tax Commn., 61 AD2d 223, 227, lv denied 44 NY2d 645). In turn, when the Audit Division employs such a method, it becomes incumbent upon the petitioner to establish error (Matter of Meyer v. State Tax Commn., supra).

C. As described, a comparison of sales per Castle's worksheets with its Forms ST-100 revealed an error margin of some 534.50 percent (see \_\_\_ Finding of Fact "4"). This discrepancy, coupled with the lack of purchase invoices, cast sufficient doubt on the reliability of Castle's records to allow the Audit Division to resort to the use of external indices in arriving at a determination of Castle's tax liability. The audit methodologies employed herein, as described, given the records supplied and the comparison results, were reasonable. In turn it is Castle's responsibility to provide evidence to refute or show error in the audit results derived therefrom.

D. Petitioner supplied no documentation or other credible evidence to support the contentions made in petitioning for a reduction or cancellation of the deficiencies in tax as determined upon audit. More specifically, the failure to substantiate the assertion that gasoline was stolen, that armed robberies had occurred, and/or that storage tanks leaked (see \_\_\_ Finding of Fact "13") warrants no consideration toward mitigation of the tax liability. Further, petitioner has offered no evidence to cast serious doubt as to the accuracy of the third-party information utilized by the Audit Division. Hence, Castle's assertion that a 534 percent error rate is more reliable than the 709 percent error rate used is rejected as unsupported. Finally, petitioner offered no evidence or argument to refute the calculation of tax due on parts and repair services sales. In sum, petitioner has totally failed to meet its burden of proving that either the method used to arrive at the assessment or the assessment itself was erroneous (see \_\_\_, Matter of Sol Wahba, Inc. v. State Tax Commission, 127 AD2d 943).

E. In 1975 the New York State Legislature added the so-called "fraud penalty" to Article 28 of the Tax Law by adding section 1145(a) (former [2]) to the Tax Law. Section 1145(a) (former [2]) provided, in pertinent part:

"If the failure to file a return or to pay over any tax to the tax commission within the

time required by this article is due to fraud, there shall be added to the tax a penalty of fifty percent of the amount of tax due (in lieu of the penalty provided for in subparagraph (i) of paragraph one) plus interest...."

The Legislature modeled this fraud penalty on the penalty provisions already existing with respect to deficiencies of, inter alia, income tax (see \_\_\_ 1975 NY Legis Ann, at 350). "The burden of showing fraud under section 1145(a)(2) has been consistently interpreted to reside with the [Audit] Division." (Matter of Ilter Sener d/b/a Jimmy's Gas Station, Tax Appeals Tribunal, May 5, 1988.) In turn, "the standard of proof necessary to support a finding of fraud requires 'clear, definite and unmistakable evidence of every element of fraud, including willful, knowledgeable and intentional wrongful acts or omissions constituting false representation, resulting in deliberate nonpayment or underpayment of taxes due and owing.' (See \_\_\_, Matter of Walter Shutt and Gertrude Shutt v. State Tax Commission, State Tax Commn., July 13, 1982.)" (Matter of Ilter Sener, supra.) It is noted that the Audit Division need not prove that the entire amount of the deficiency is due to fraud, but only that some portion of the deficiency for each period at issue is due to fraud (Tax Law § 1145[a][2]). For a taxpayer to be subject to a civil fraud penalty, willful intent is a critical element; the individual or the corporation, acting through its officers (herein Lufti Ahmed), must have acted deliberately, knowingly, and with the specific intent to violate the Tax Law. ( Matter of Cousins Service Station, Inc., Tax Appeals Tribunal, August 11, 1988.)

F. Based upon the evidence presented, the Audit Division has met its burden of proving that the imposition of the fraud penalty was warranted in this matter and should be sustained. Without full elaboration, the following factors support such conclusion:

1. The comparison of Castle's sales and purchases worksheets to the ST-100's showed an enormous understatement of sales of 534.50 percent.
2. The comparison of reported taxable sales to sales per Power Test verification resulted in an even greater margin of error of 709.95 percent.
3. The margin of error in both measures is so great that it is beyond belief that a person of ordinary intelligence and ability would not recognize the discrepancy, thus negating any claim that the error in reporting is attributable to Castle's accountants.
4. Although Lufti Ahmed did not have an extensive educational background and had a slight language barrier, his plea of ignorance of financial matters is all but negated by his 15 year employment as an insurance agent with the John Hancock Company.
5. The guilty plea, executed Affidavit for Judgment by Confession, and the statements made to law enforcement agents pertaining to the indictments by Mr. Ahmed weigh heavily against Castle.
6. In his affidavit for judgment by confession, Mr. Ahmed admits to fraudulent filings for a period including 2 of the 6 audit quarters (11/30/80 and 2/28/81; see Finding of Fact "10-c"). In turn there is evidence that the same pattern of business conduct was followed by Mr. Ahmed in his operation of petitioner throughout the audit period. Accordingly, there is ample evidence to support the



conclusion that the underpayment at issue was deliberate, knowledgeable and intentional, thus warranting imposition of the fraud penalty (said penalty for the period June 1, 1979 through May 31, 1980 to be limited in amount to the amount assessed [see\_\_\_ footnote "1"]).

G. In view of the foregoing, Issue III is rendered moot.

H. That the petition of Castle Service Center, Inc. is hereby denied and the notices of determination and demands for payment of sales and use taxes due are sustained.

DATED: Albany, New York  
September 15, 1988

/s/ Dennis M. Galliher  
ADMINISTRATIVE LAW JUDGE